Wealth Management
Dominion Securities

RBC Dominion Securities inc.

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Market update

With 2017 just coming to an end, it is therefore timely to review the economic conjuncture we were in during the same period a year ago. Donald Trump had been in power for only a few months and economic indicators were sending encouraging signs of improvement, which could signal an acceleration of profits for companies. Despite this excellent news, there were some elements of concern, including the difficulties for Donald Trump to implement his various reforms, the anticipated rise in interest rates, political instability (mainly in Europe) and geopolitical risks (North Korea). To our great satisfaction, we saw those fears gradually fading throughout the year, giving way to a robust economic growth, which in turn led to a sustained acceleration of corporate profits (up 11% year-over-year). This economic conjuncture allowed us to achieve excellent returns for the year 2017.

The portfolio in 2017

We mentioned in our June comment that we were comfortable with the portfolio holdings in early 2017. We were greatly rewarded by several of them, achieving excellent returns on the following stocks: Dollarama (+59%), Amazon (58%), Facebook (56%), Apple (48%), Visa (47%), Alphabet / Google (36%), Waste Connection (34%) and Honeywell (34%) to name but a few. In addition, Energizer Holdings, a more recent addition to the portfolio, has also performed well with an increase of more than 30% since our purchase in August.

Risk management is an integral part of our investment discipline and this principle is even more important after years of high returns for the equity market. Hence we regularly rebalance your portfolio. This is why, we have recently decided to reduce Dollarama (profit of more than 150% since the initial purchase) and Pfizer (+40%). We also sold the position in the Horizon index exposed to oil stocks (+ 10%). To reduce the tax impact of these transactions, we realized losses on two stocks that did not perform well in 2017, Precision Drilling and CC&L Market Neutral. It is important to remember that the excellent returns we have since 2009 have resulted in a large accumulation of unrealized capital gains in your portfolios. Our investment discipline requires us to trigger some gains from time to time in order to protect your capital over the long term.

Important changes due to new technologies

In January we attended the annual conference with our analysts and strategists in Toronto. Once again, new technologies were at the heart of our discussions. Not only new technologies create opportunities for some companies, but they also represent a threat to many others, especially those that will not be able to innovate nor adapt. In recent years, a better understanding of technological issues has allowed us to gain confidence in the business model of companies such as Alphabet, Facebook, Apple and Amazon. Now, our attention is turning toward companies in more traditional sectors that are likely to undergo major disruptions with the arrival of these new technologies and the potential entry of new players more agile with massive financial means. Several well-established companies will be threatened over the next few years by artificial intelligence, autonomous vehicles, renewable energy, etc. We just have to think of Amazon, which initially turned the book industry upside down and then took the consumer goods industry by storm (clothing, toys, tools, etc.). We can also add Amazon's new venture in the grocery sector with the purchase of Whole Foods Market and its debut in the market prescription drug delivery. With all these different sectors shaken by the same company it is safe to wonder how many other start-ups or more advanced companies will rethink ways of doing things and enter some traditional industries. Aware of this new reality, we remain vigilant against these risks, in hope to avoid certain pitfalls.

Our outlook for 2018

The expression "signs of recovery" that we used at the beginning of this document gained popularity in the aftermath of the Great Recession and indicated cautious optimism about the economic outlook. In many cases signs of recovery have dissipated and expected growth has not materialized. However, in 2017 and since the beginning of this new year, things are different. Major global economies appear to be evolving in a synchronized manner and economic growth is robust. Future will tell us if the tax cuts that President Donald Trump has granted US corporations will really be good for the economy. Although this additional stimulus seemed to propel the markets to highs in January, there are fears now that these tax cuts will revive the specter of inflation. An inflationary scenario would force the US Federal Reserve to tighten its monetary policy faster than expected. In this context, markets may experience moments of increased volatility.

At the dawn of 2018, the S&P 500's expected earnings growth was 7% for the year. Following the announcement of the tax cut, strategists now forecast a rise of 17.9%, bringing the market valuation to a price-earnings ratio (P/E) of 17x. Not necessarily a bargain, but price-earnings ratios generally do not reach peaks before earnings and business cycles do. We therefore do not believe that the current valuation is preventing markets from realizing attractive gains in the coming year, especially if earnings continue to grow as expected. However, we must temper our expectations of returns for the next few years. Valuation at the point of entry into the market has a significant influence on the expected future return. Historically, if one buys the S&P 500 at a P/E of 12, the 10-year average annual return is around 10%. If the purchase is made at 17 times, the annual average over 10 years decreases to about 7%. According to this same logic, a balanced portfolio (50% equities, 50% fixed income) should generate a return of about 4% to 6% on average for the next 10 years (7% for equities and 3% for fixed income), which is below our average of +/- 9% since 2009 (9 years).

We therefore believe that 2018 will be another positive year for the market. However, the trajectory can hardly repeat the feat of last year from the point of view of stability. 2017 will remain in the history as being one of the least volatile year reported, even breaking the record for the longest period without experiencing a decline of 5% (a total of 20 months). It is easy to think of factors that could lead to episodes of volatility. NAFTA is at the forefront in Canada, while the steady rise in interest rates is another.

It is also the rapid rise in bond yield as well as too much complacency from the part of investors at the beginning of the year, which are responsible for the volatility of the last few days. Fear caused by technology, which we mentioned earlier, is also responsible for a greater volatility in the markets. Indeed, the use of automated computer programs is becoming more widespread and in some circumstances the algorithms used can systematically sell the market or securities without any fundamental consideration. This trend will certainly continue to accentuate volatility in the market over the next few years.

US 10-year bond yields rose from 2.42% in January 2017 to 2.84% in early February 2018, which is a significant increase. We mentioned at the beginning of 2017 having gradually positioned the equity portfolio, as well as the bond portfolio for this eventuality. The bond portfolio remains invested with a short duration, hence it is less sensitive to rate changes. The majority of our preferred shares benefit from these rate hikes. We further repositioned the equity portfolio at the beginning of the year by collecting profits on BCE and Canadian Apartement, securities which correlated negatively to rate hikes. We have also reduced our position in Canadian National Railways to protect us from risks emanating from NAFTA renegotiations. We have reinvested the proceeds in securities that should perform better in a rising interest rate environment: Manulife and Onex. We also added two new positions: WSP Global to maintain an adequate weighting in the Canadian industrial sector and Nutrien, company born from the merger between Agrium and Potash, in order to be a little more present in the raw materials sector, in this case fertilizers.

After the massive interest rate cuts following the 2008 financial crisis, the main central banks are now trying to normalize their monetary policies by gradually raising interest rates in order to give themselves more leeway to face possible medium and long term bumps in the economy. These rate hikes confirm that central banks have confidence in the current economic growth. For the moment, however, we do not believe that rates have reached a restrictive level for the economy and the latter stands on solid fundamentals. Our economic indicators continue to show a low probability of recession for the coming year. Expected earnings growth for US companies is excellent at a level of 17.9% for 2018. The recent decline in the markets and the increase in anticipated earnings for 2018 have resulted in valuations at more reasonable levels (17 times) which are close to the average of the last 20 years (15.7 times).

We remain convinced that the fundamentals are in favor of equities. In addition to the support provided by the robust economy and strong earnings growth, valuations have improved recently. Although central banks will continue to tighten their monetary policies, rates are still historically low and will remain at levels that should not significantly hinder economic growth. We are therefore in favor of the equity market for 2018 and perhaps beyond next year.

We hope you enjoyed our report and invite you to contact us for any questions, comments or suggestions.

Sincerely,

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